The Real Estate ANALYST

MARCH 13
1959

Volume XXVIII

Number 10

As I see it

ARE SMALL EQUITIES DESIRABLE?

WHY does a man go into debt? There are two answers. The most obvious is that he does not have enough money to pay cash; the other, he hopes the money he does not spend by paying cash will earn more than he has to pay for the money borrowed. In the latter case, he accepts the risk and responsibility that the money he invests may not make enough to pay for the money he borrowed, thus sustaining a loss. On the other hand, should the money he invests make more than his cost to borrow he stands to gain in the process.

In a period of rising prices, his chances for gain are increased. In periods of falling prices, his chances for loss are increased. Let us assume two men each with $8,000 cash in 1948 and each in the 26% income tax bracket. Each man, Mr. Jones and Mr. Smith, purchased a $20,000 home. Mr. Smith paid down $8,000 and borrowed $12,000 at 5½% interest for a period of 25 years. Over the 10-year period his total principal payments on a monthly amortized loan amounted to $4,017 and his total interest payments came to $5,843. At the close of 1958, his financial position was something like this:

Mr. Smith -- $8,000 down, borrowed $12,000

Expenditures		Equity	
Net interest expense ($5,843 less 26%)	$ 4,324	Original mortgage	$12,000
Principal paid in	4,017	Less principal payments	4,017
	$ 8,341	Loan outstanding	7,983
		Property value 1958	24,360
		Equity	$16,377

In contrast, Mr. Jones decided to pay $2,000 down on a $20,000 home in 1948, leaving him $6,000 cash in his savings account. At the close of 1958 his financial position looked something like this:

Mr. Jones -- $2,000 down, borrowed $18,000

Expenditures		Equity	
Net interest expense ($8,682 less 26%)	$ 6,425	Original mortgage	$18,000
Principal paid in	4,498	Less principal payments	4,498
	$10,923	Loan outstanding	13,502
		Property value 1958	24,360
Interest on $6,000 savings account @ 3½% less 26%	1,554	Equity	10,858
		Cash on hand	6,000
	$ 9,369		$16,858

Comparing the two situations, Mr. Jones paid $1,028 more than Mr. Smith over the 10-year period and increased his equity (and cash position) by only $481 more than Mr. Smith. The reason for this difference should be obvious. For example, Mr. Jones is borrowing money at the rate of 5½% interest and is lending (the effect of a savings account) at the rate of 3½%. Naturally, Mr. Smith is in a far better position by having paid more down thereby reducing his interest costs over the period. However, his liquid position is not so favorable as that of Mr. Jones.

One of the advantages of Mr. Jones' slim equity and liquid position in a rising market is having $6,000 free to invest in an area that he hopes may bring him a return in excess of the interest he is paying on his loan.

Remember that Mr. Jones has already purchased his home with $2,000 down, leaving him $6,000 to invest elsewhere. Say in 1948, as an alternative to keeping his money in a savings account, he invested the total $6,000 in one of the largest and most conservative corporations in the United States. This move still allows him a high degree of liquidity at the same time affording possible capital appreciation. Had this been the case, Mr. Jones' financial position at the end of 1958 would then be much more favorable than it would have been had he placed his cash in a savings account or paid a total of $8,000 down on his own residence.

Mr. Jones -- $2,000 down, borrowed $18,000, invested $6,000

Expenditures		Equity	
Net interest expense		Original mortgage	$18,000
($8,682 less 26%)	$ 6,425	Less principal payments	4,498
Principal paid in	4,498	Loan outstanding	13,502
	10,923	Property value 1958	24,360
Dividend payments less 26%	2,894	Equity	10,858
	$ 8,028	Market value of sec. 1958	9,654
			$20,512

The picture has now changed to one in which Mr. Jones has paid out $313 less than Mr. Smith and has a net worth of $4,135 more than Mr. Smith and has a more liquid position than Mr. Smith.

Some still view the securities market with a dim eye despite the conservativeness of the corporation used in this example and would prefer to put all their investable funds in an area with fixed and more tangible assets.

Let us assume another choice of investment for Mr. Jones' $6,000. Say for instance he purchased a 2-family flat in 1948 for $20,000 paying $6,000 down and borrowing the balance of $14,000 at 5½% interest for a period of 25 years. For tax purposes we will allow $18,000 for the building and $2,000 for the land. From 1948 to the end of 1958 he would have paid $6,914 in interest and $3,526 in principal payments. At the end of 1958 his financial position would look something like this:

Mr. Jones -- $2,000 down, borrowed $18,000, invested $6,000 in 2-fam. flat

Home

Expenditures		Equity	
Net interest expense ($8,682 less 26%)	$ 6,425	Original mortgage	$18,000
Principal paid in	4,498	Less principal payments	4,498
	$10,923	Loan outstanding	13,502
		Property value 1958	24,360
		Equity on home	10,858

2-family flat, $6,000 down

		Equity	
Rental income	$23,470		
Expenditures		Original mortgage	$14,000
Net interest expense ($6,914 less 26%)	5,116	Less principal payments	3,526
Principal paid in	3,526	Loan outstanding	10,474
Taxes, $3,600 / Maint., $3,000 less 26%	4,884	Property value 1958	24,360
Total expenses	$13,526	Equity in flat	13,886
Income before depreciation	9,944	Income after taxes plus depreciation	9,231
Depreciation allowance (4% straight line)	7,200		$23,117
Net taxable income	2,744		
Income tax @ 26%	713		
Income after taxes	$ 2,031		

Mr. Jones invested $6,000 in a 2-family flat. The income from the flat over the entire period more than offset the amortization payments, taxes, maintenance, and depreciation. Therefore, for an investment of $6,000 in 1948 Mr. Jones in 1958 has an equity plus cash income and depreciation of $23,117 -- nearly four times his original investment. Total equity on his original $8,000 comes to $33,975.

The foregoing illustrations show how two theoretical investors would have fared with their real estate investments during the past 10 years. Can we assume that similar policies would bring similar results during the next 10?

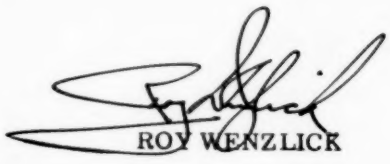
It seems to me that it is probable that inflation will continue at an average rate for the next 10 years similar to the average rate for the last 10. Every effort is really being made by the Administration to stop inflation, and the Federal Reserve Board is aiding in every way possible. The difficulty is primarily with the American people themselves. The general public apparently will always vote for a free spending administration which does not increase taxes. We are seeing this illustrated at the present time in France. De Gaulle is making a really valiant effort to halt inflation there, which means a program of relative austerity, in order to preserve the French economy. In the election

a few days ago those who opposed his program polled the biggest increase. This is probably a forecast of what will happen here.

If we continue to appropriate more money than we raise through taxes, the value of our money will continue to decrease, the cost of building will continue to increase, and the value of existing useful buildings will continue to rise.

In the end the investor is going to be faced with the choice of investing either in dollar obligations (Government bonds, corporate bonds, mortgages, annuities, savings accounts, etc.) or in equities (common stocks or real estate). If he invests in dollar obligations, the strong probability is that the income on these obligations will not offset the loss in principal. If he invests in equities, he at least has a good chance of maintaining the purchasing power of his principal.

The general public has bid up the price of good common stocks to the point where their selling price is above their intrinsic value. Real estate has not undergone the same amount of inflation and seems to be the best hedge still available for the average investor.



ROY WENZLICK